# 8 Economic Reforms


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**Introduction**

The planners of independent India faced challenges of social and economic development. For this reason, they adopted the mixed type of economic system which laid greater emphasis upon socialist pattern of planning.

However, by the eighties, many experts felt that the strategies of planning adopted from 1947 to 1990 failed to attain the goals of economic growth and development as they proposed several state imposed regulations on economic activities. Besides, in the early nineties the international monetary organizations guided by the developed nations of the world imposed a precondition for providing further monetary assistance to India that India must reform its economic policies by reducing excessive controls on economic functioning. There was a severe balance of trade deficit and India had to borrow foreign exchange from international institutions. Balance of trade is an accounting statement showing a country's expenditure on imports and income from exports. Thus, since 1991, India reformed her economic policies for which necessary institutional and regulatory changes were also brought about.

## 8.1 Objectives of Economic Policy Reforms Since 1991

The changes brought about in economic policies since 1991in order to steer a change in the economic system of India; from one which was highly regulated by the state to one which is more market oriented; as well as to reduce the extent of public sector in the mixed economic system came to be known as economic reforms. The objectives of these reforms were stated as under:

**8.1.1** Increasingly encourage private and foreign investments in order to utilize India's abundant natural and human wealth in the process of economic development in a more productive manner.

**8.1.2** Optimum and efficient allocation of the nation's resources.

**8.1.3** Restrict expenditures of the state and channalize the resources recovered from disinvestment in public enterprises towards increasing utilities which enhance welfare of the people.

**8.1.4** Increase domestic income, employment and export income of the country.

**8.1.5** Increase competitiveness of the Indian economy.

**8.1.6** Ensure steady economic growth and development of the Indian economy in the long run. In order to fulfil these objectives, systematic reforms in economic policy were initiated in 1991 which had three components :

(1) Liberalization (2) Privatization (3) Globalization

## 8.2 Liberalization

Liberalization means increase in the freedom of private enterprise by allowing greater play of market forces and reduced interference by the state; in a way relaxing policy restrictions imposed on economic activity.

Increasing the role of private sector and market oriented processes in economic planning in place of state regulated economic processes in India's mixed economic system is called liberalization of Indian economy. In the process of liberalization,

(1) there is a gradual decline in the controls imposed by the state in economic functioning,

(2) the role of market forces of demand and supply increases in economic decision making,

(3) the private sector is systemically allowed to enter the investment areas reserved for the public sector,

(4) protection granted by the state to domestic industries against foreign competition is systematically reduced. This implies that the discrimination between domestic and foreign enterprises by the state is gradually narrowed down. For example, if the state has imposed restrictions on cheaper imports and better quality importes as well, to enable sale of domestic goods then such restrictions are reduced.

## 8.3 Process of Liberalization in India

Liberalization in India was implemented as a gradual process. Initially investment rules were simplified for domestic producers and investors and subsequently for foreign investors. Likewise, initially the consumer goods sector was opened up for investment by foreign companies and then service sector and later on the financial sector. Thus, it was a strategic liberalization process.

The process of bringing about such economic changes which is also called economic reforms calls for systematic changes in policy regulations. Some important regulatory changes which were brought about by the Indian legislative body were,

**8.3.1** MRTP Act was replaced by Competition Act. (Monopolies and Restrictive Trade Practices Act, 1969 : Act preventing enterprises from growing very big and establishing monopolies. Competition Act, 2002 : This Act replaced MRTP and was aimed at reducing unhealthy competition among enterprises).

**8.3.2** FERA was replaced by FEMA. The word regulatory was removed from FERA and replaced by the word Management. (Foreign Exchange Regulation Act, 1973 : The Act regulating foreign exchange earnings and transactions of enterprises. Foreign Exchange Management Act, 1999 : The Act managing foreign exchange earnings and transactions of enterprises instead of regulating those).

**8.3.3** Major changes were made in the industrial policy of which one noteworthy was, opening up for private sector the areas reserved for investment only by the public sector (now only three sectors are reserved for the public sector namely, atomic energy, some minerals related to atomic energy and railways); another noteworthy change was raising the investment limit in the definition of small scale units so that with higher investment a small scale unit can adopt modernization.

**8.3.4** The procedure for foreign investment became more investor friendly and in many sectors 'automatic licensing route' was introduced for investment by foreign companies in India.

**8.3.5** Besides relaxations in the industrial policy, relaxation in export-import rules were announced. Foreign exchange was allowed to be converted at market rates instead of the earlier method of convertibility only at the official rates and expenditure on subsidies was attempted to be reduced as part of the fiscal policy changes.

## 8.4 Privatization

Privatization means process of introducing private ownership in publicly owned enterprises and increasing the size of private sector.

In India, the public sector enterprises are owned and managed by the state (Government). Privatization means process of transferring ownership of economic enterprises from public sector to private sector either partially or fully.

## 8.5 Process of Privatization

Privatization can take place in the following ways :

(1) through disinvestment (2) by reducing the number of areas reserved for investment only by the public sector and opening them for investment by the private sector (3) by establishing public – private partnership businesses.

### 8.5.1 Meaning and Process of Disinvestment in India :

**Meaning :** Disinvestment means a process where the state reduces its share of investment in a public enterprise or draws back its investment completely by selling its shares to the private sector. Thus the process by which the state 'disinvests' from public enterprises is called disinvestment.

**8.5.2 Process :** The following two aspects are important to understand the process of disinvestment.

(A) Sell all the shares of the state in a public enterprise to the private sector which is called complete disinvestment.

(B) Sell some shares of the state in public enterprises to the private sector for example, 29% or 49% which is called partial disinvestment. If less than 51% shares are transferred to private sector then it is called minor disinvestment and if more than 51% shares are transferred to private sector then it is called major disinvestment.

Besides owning public enterprises, the state also held control over certain areas of investment. Certain areas of strategic importance and public utility services were not open for investment by the private sector. However after privatization in 1991, most of these areas were declared open for investment by the private sector.

E.g. Banking, Education, Comunication, Transportation are now open for private and foreign investment.

**8.5.3** Now only the areas of atomic energy, certain minerals related to atomic energy and railways are reserved for investment by public sector.

**8.5.4** After independence there was a significant rise in the number of public sector enterprises under the central government. After 1991 they didn't rise significantly. On March 31, 1951 there were 5 public sector enterprises under central government, which became 233 in 1990 and 217 in 2010 and were around 300 in 2015. The process of disinvestment from old enterprises continues while the state may also set up new enterprises.

## 8.6 Globalization

Globalization is the process of increasing a country's economic integration with the rest of the world by increasing trade in goods and services, increasing movement of physical and financial capital, increasing exchange of technology and increasing investments between borders. It can be undertaken by gradually decreasing the policy controls which served as impediments to foreign trade.

## 8.7 Process of Globalization in India

In 1991, International Monetary Fund (IMF) declared several nations as highly indebted to it and thus imposed upon them to globalize and upgrade the technologies and growth of their nations. This was a precondition before sanctioning further loans to these nations. India was one of those and accordingly India had to relax its policies of granting protection to domestic industries from foreign competition. And, thus India began globalizing by allowing more trade with other nations. The following marked a systematic globalization process,

**8.7.1** Import – Export licensing policy was made simpler and easy.

**8.7.2** India became member of World Trade Organization in 1995 which means abiding by its rules of freer world trade.

**8.7.3** Introducing convertibility of Indian rupee into other currencies at market rate by gradually reducing conversion at the official rate. Thus, value of our currency is determined by trade.

**8.7.4** There was sector wise and systematic increase in foreign direct investment in India.

**8.7.5** Investors and producers in India were allowed to increase financial collaborations with their foreign counterparts.

**8.7.6** State become more indifferent in policy matters between domestic and foreign investors and producers; that is, undue protection for Indian investors against foreign competition was lifted.

**8.7.7** Social and cultural ties with other nations were also encouraged including relaxations by many nations in granting visas.

## 8.8 Foreign Investment in India

Foreign investment became an important component of the process of globalization. Under a relatively closed and controlled economy, excessive foreign exchange needs of Indian economy for purpose of investment, imports of essential goods and services, technology imports etc. were met by borrowings from international organizations and foreign governments. As there were several controls on foreign investments, we had to buy more goods and technology from abroad for which we needed foreign exchange. After 1991, India allowed direct investment in certain areas in increased proportion. Such investment would decrease our dependence on foreign borrowings as investment by efficient foreign companies will create employment, produce variety of goods, raise tax incomes and bring technology.

### 8.9 Types of Foreign Investment

Foreign capital comes in two ways. (1) Foreign Institutional Investment (2) Foreign Direct Investment

**8.9.1 Foreign Institutional Investment (FII) :** Some foreign companies do not invest in plant and machinery in another country say, India. They invest funds in financial institutions and bond / stock / share markets in another country. They buy such stocks from the bond / share market in that country. Such investment is called Foreign Institutional Investment / Portfolio investment and such companies have to register in India as Foreign Institutional Investors. In India, they can invest only up to a limit specified by rules. They have no direct stake in the management of the home company. Hence financial capital comes to the home country through the stock market.

This type of investment comes to the home country in a very short span of time when foreign companies buy shares of home country in large amounts and it can also leave the home country in an equally short span of time when foreign companies sell the home country's shares in bulk. Hence funds take a flight in and out of the country easily and thus this is considered to be a risky and unstable kind of foreign capital.

**8.9.2 Foreign Direct Investment (FDI) :** When the home country invites capital by allowing foreign investors / companies to produce and sell directly in India such investment is called foreign direct investment.

In FDI, foreign companies directly set up their business in India by constructing their plants, bringing in technology and producing; or by collaborating with Indian companies to do so. These companies either manage the entire business or have a say in management if they are collaborating partners.

### 8.10 Nature of Foreign Direct Investment

The nature of FDI can be stated as under :

(1) It is a physical establishment in the form of direct investment and hence stable form of investment.

(2) It brings machines, materials and wealth to the home country.

(3) It brings new technology to the country.

(4) It brings a different work culture along with it.

India has systematically allowed FDI in increased proportion in various sectors and India's foreign exchange earnings have increased.

### 8.11 India's Foreign Trade Policy

This policy regulates India's trade with other countries.

The foreign trade policy of India always faced the following challenges :

**8.11.1** Need to control certain imports in order to protect domestic production from competition by foreign goods

**8.11.2** Ensure enough imports of technology, machines, spare parts as well as resources to help increase domestic production and import substitution.

**8.11.3** Control imports of goods unessential for India's development in order to save scarce foreign exchange.

**8.11.4** Encourage exports to earn foreign exchange in order to pay for necessary imports.

**8.11.5** Many Indian goods could not compete against the quality of foreign goods and hence increasing exports was a challenge for trade policy.

**8.11.6** Promote export of goods produced by small scale sector.

**8.11.7** The challenges of foreign trade are different from those of domestic trade as foreign trade involves foreign exchange.

The foreign trade policy of India was formulated and amended from time to time to deal with the above challenges in the best possible manner.

**8.12 Stages of India's Foreign Trade**

Let us understand India's foreign trade policy in two sections.

(1) foreign trade policy before globalization and (2) foreign trade policy after globalization

**8.12.1 India's Foreign Trade Policy before Globalization (1991) :** In the initial years after independence, India had to set up its administrative, economic and state functions in the interest of the nation. After experiencing long period of foreign rule which was established after East India Company came to India for trade, India was not ready for many imported goods. At the same time, because of poverty and scarcity of foreign exchange, India was compelled to regulate imports. Exports were also limited.

India adopted a mixed economic system after independence and steered strategic development through planning. India started setting up basic industries of large scale and in order to establish such huge industries we had to import costly machinery, technology and spare parts. Thus, scarcity of foreign exchange emerged and restrictions were imposed on imports of consumer goods.

Hence, in the foreign trade policy in the initial years emphasis was laid upon measures of protection for the domestic industry against foreign competition, various import restrictions were imposed and export promotion measures were introduced. Later on, along with the traditional items of exports like agricultural produce, handicrafts, gems and jewellery, the exports of non traditional industrial goods were also promoted.

Rates of exchange were officially determined and the rupee was devalued in order to increase exports and reduce imports. With devaluation, imports did become costly but since the items of imports were necessary for India's industrialization there was no significant decline in imports. Import bills increased and there was a deficit in India's Balance of Payments. A policy of import substitution was also adopted. Import substitution is a policy of substituting imports by domestically produced goods. That is, imports are reduced and replaced by domestic goods.

**8.12.2 India's Foreign Trade Policy after Globalization (1991) :** After 1991 economic policies in India were reformed to enhance trade and investments. Foreign trade policy was made outward looking from a restrictive inward looking one. Indian rupee was allowed to be converted into foreign currencies at market rates from the earlier official conversion, import – export licensing was made easy; now strict licensing exists only for Crude, edible oils and chemical fertilizers.

With promotion of FDI and privatization, foreign companies can now sell variety of goods in India. After globalization India's trade with non-traditional trade partners or new countries increased and new trade policy aimed at increasing India's percentage share in world trade. India became a member of World Trade Organization (WTO) in 1995 and trade policy changes were made according to WTO rules; For example, changes were made in import-export rules for agricultural goods, trade related investment measures and so on.

**8.13 Evaluation of Economic Reforms**

From 1951, India adopted socialist pattern of planning and in order to set up a society with equality, it adopted narrow, regulated and inward looking economic policies. After 1991, India made these policies liberal, market-oriented and outward looking for promoting trade and development.

This transformation was called the process of economic reforms. Evaluation of these reforms after almost 25 years can be done as under :

**8.13.1 Favourable Effects of Economic Reforms :** Economic policy reforms in the form of liberalization, privatization and globalization increased the significance of the market forces of demand and supply owing to which determination of prices, wages and interest became market oriented and more realistic and less regulated. Besides, owing to reduced regulations, the decisions regarding production, investment and distribution also became market oriented. The stern difference between domestic and foreign investments narrowed down. And, certain effects favourable to India can be observed.

(1) Consumers started getting variety of goods of international quality easily and at reasonable prices.

(2) India's foreign exchange reserves increased.

(3) India's exports increased.

(4) Along with increase in FDI, the risk of certain investments and debt burden of the state for importing costly technology etc. reduced.

(5) Large scale investments increased in the private sector which in turn increased production and employment.

(6) Factors of production became more mobile within the nation and between nations.

(7) Under an era of too many regulations, corruption, bureaucratic hurdles, delays in decision making and inflexibility in administration had become a common feature in policy implementation. All these are found to have gradually reduced after reforms.

(8) Certain sectors which are significant in growth but neglected owing to scarcity of capital and government regulations got an impetus with private sector's investment initiatives. For example, natural gas pipelines, modernization of railways and so on.

(9) Shortages of goods and services became a thing of past; rather variety increased.

(10) Social and cultural ties with other nations improved.

**8.13.2 Unfavourable Effects of Economic Reforms :** The new economic policies also raised some social concerns in India like,

(1) Small and cottage industries could not withstand competition from multinational companies.

(2) Globalization started along with privatization. Before the Indian private sector became efficient, Indian companies started facing competition from foreign companies and some Indian companies suffered a setback.

(3) Subsidies were reduced in many sectors and the services of these sectors became expensive.

(4) Exchange rate determination (determining value of Indian currency vis-a-vis foreign currencies) was left to the market and hence fluctuated more. Many companies suffered owing to such fluctuations.

(5) Some foreign companies started selling their goods at unduly low prices in India. As a result many Indian companies selling similar goods received a setback as they cannot produce and sell at such low prices. Such a method of foreign companies is called 'dumping'.

(6) Many policies of World Trade Organization imposed strict quality measures and posed difficulties for exports of countries like India. Especially for exports of agricultural goods.

(7) To cope with the speed of privatization and globalization, the infrastructural facilities like electricity, roads etc. proved insufficient.

(8) Inequalities of economic power increased.

(9) The production and sale of life style goods increased against necessities.

(10) Some people believe that the social-cultural foundations of India are threatened because of globalization.

## Exercise

**1. Choose correct option for the following from the options provided :**

(1) From which year the economic reforms of LPG were introduced in India ?

(A) 1947 (B) 1951 (C) 1991 (D) 1980

(2) From which year was FEMA introduced in India ?

(A) 1973 (B) 1980 (C) 1991 (D) 1999

(3) In the recent times which of the following area is reserved for exclusive investment by the public sector ?

(A) Fertilizer (B) Television (C) Automobile (D) Railway

(4) What is the policy of producing the goods domestically which are similar to imports called ?

(A) Privatization (B) Liberalization (C) Import substitution (D) Globalization

(5) What is the investment made by foreign companies in our country called?

(A) FERA (B) FEMA (C) FDI (D) NRI

**2. Answer the following questions in one sentence :**

(1) Give the full form of FERA.

(2) Give the full form of FEMA.

(3) Give the full form of FDI.

(4) Give the meaning of liberalization.

(5) Give the meaning of globalization.

(6) Give the full form of FII.

**3. Answer the following questions in short :**

(1) Give the meaning of and components of economic reforms.

(2) Give the full form of MRTP and state the reasons behind the formulation of this act.

(3) Give the meaning and types of disinvestment.

(4) Explain the reasons which compelled India to adopt reforms in 1991.

(5) Give a short explanation about Foreign Institutional Investment.

**4. Answer the following questions in brief points :**

(1) Give the meaning and important aspects of the process of globalization.

(2) Give the meaning and nature of Foreign Direct Investment.

(3) State the challenges before the foreign trade policy of India.

(4) Explain the foreign trade policy after globalization.

(5) State the adverse efects of economic reforms.

**5. Answer the following questions in detail :**

(1) Give the meaning of liberalization and explain the changes which came about with it in India.

(2) Evaluate the effects of the economic reform process of India which began in 1991.

(3) Give the meaning of privatization and explain its process in India.

## Glossary

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| **Economic Reforms** | : | It is a process of systematically reducing policy regulations and excessive state imposed controls in economic functioning (e.g. decisions related to investment, production, trade etc.) in India. |
| **Liberalization** | : | It is the process which increases the scope of private enterprises, private sector's say in economic functioning, market oriented decision making by relaxing the policy regulations regarding the same. |
| **Privatization** | : | Privatization means process of transferring ownership of economic enterprises from public sector to private sector either partially or fully. |
| **Globalization** | : | Globalization is the process of increasing a country's economic integration with rest of the world. |
| **Disinvestment** | : | Disinvestment means a process where the state reduces its share of investment in a public enterprise or draws back its investment completely by selling its shares to the private sector. Thus the process by which the state 'disinvests' from public enterprises is called disinvestment. |
| **MRTP – Monopolies and Restrictive Trade Practices Act, 1969** | : | Act preventing enterprises from growing very big and establishing monopolies. |
| **Competition Act, 2002** | : | This Act replaced MRTP and was aimed at reducing unhealthy competition among enterprises. |
| **FERA – Foreign Exchange Regulation Act, 1973** | : | The Act regulating foreign exchange earnings and transactions of enterprises. |
| **FEMA - Foreign Exchange Management Act, 1999** | : | The Act managing foreign exchange earnings and transactions of enterprises instead of regulating those. |

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